PRIVATE DIRECTORS ASSOCIATION®
Creating Value Through Board Excellence

CHICAGO

Monthly Newsletter

May 2019

Upcoming Events

May 15
NEW YORK | Private Director Symposium
May 15, 2019 - 4:00 PM - 8:00 PM
EY Offices
5 Times Square
New York, NY 10036

May 15
CHICAGO | The Value of an Independent Board and Getting Started with a PDA Model Board Meeting℠
May 15, 2019 - 5:00 PM - 7:30 PM
Bank of America
135 S. La Salle Street
Chicago, IL 60603

May 21
CHARLOTTE | Boards in Family Businesses: Composition, Non-family Members, & Twists and Turns
May 21, 2019 - 4:45 PM - 7:30 PM
Bank of America Corporate Center
100 N Tryon Street, 59th Floor Dining Room
Charlotte, NC 28255

Jun. 19
CHICAGO | Private Equity Company Board Strategies for Managing Across Business Cycles
June 19, 2019 - 5:00 PM - 7:30 PM
University Club of Chicago
76 E Monroe Street
Chicago, IL 60603

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Jonathan Friedland, a partner with Sugar Felsenthal Grais & Helsinger LLP, regularly helps financially distressed businesses and their boards navigate out of trouble. He is also expert at helping buyers of distressed businesses. Jonathan is rated AV® Preeminent™ by Martindale-Hubbell, 10/10 by AVVO, and enjoys several other similar distinctions. He spent an earlier part of his career at Kirkland & Ellis, first as an associate and then as a partner. He is lead author of the 1,800+ page Strategic Alternatives For And Against Distressed Businesses and the 2,000+ page Commercial Bankruptcy Litigation. Jonathan clerked for a federal judge before entering private practice and served for several years as an Adjunct Professor of Strategic Management at the University of Chicago's Graduate School of Business, and as the first visiting professor at the Clayton School of Entrepreneurial Law at the University of Tennessee College of Law. Jonathan is also founder and publisher of FinancialPoise™.

What to Do When You're a Corporate Director of a Private Company Facing a Financial Crisis

Question: a company whose board you sit on is facing an existential threat. You and the other board members were just advised by the CEO that the company is out-of-formula on its line of credit. The senior secured lender (the bank) has put the loan in workout and has threatened to freeze the revolver. The company may run out of cash in the next two weeks and may be unable to meet its payroll obligations. What actions should you consider suggesting to the rest of the company's board of directors?

Potential answers:

a. Call an immediate board meeting and seek counsel experienced in advising financially distressed companies and their boards.

b. Ask the CEO to go to Las Vegas and bet all the company's cash in a blackjack game. This is smart because equity is worth nothing as things currently stand, so if the CEO loses, then equity holders will be no worse off than they were before, but if the CEO wins, then equity will be back in the money.

c. Resign. You and your fellow board members should all resign immediately to make sure none of you can be sued for breach of fiduciary duties.

Answer (a) is obviously right and Answer (c) is obviously wrong (if these answers are not obvious to you right now, no worries, they will be by the end of this article). But would you believe that Answer (b) is not clearly wrong? Well, given the extreme facts offered here, it is wrong, but the broader principle – that a company can make decisions that may hurt creditors for the benefit of equity holders even when that company is insolvent – is counterintuitive to many. Jump down to #9 below if you can't wait for this notion to be explained.

Executive Summary of a Tremendous Amount of Law

You can read volumes about this topic. Just run an internet search for "fiduciary duties in the zone of insolvency" and you'll see what I mean (and if you add my name to the search, you'll find plenty of ink I've spilled on it). The Cliff Notes version **(which comes with the huge caveats that a lot of detail is left out for brevity and that you'd be foolish to take any action based on reading just this alone)** is as follows:

1. Fulfilling your fiduciary duties is only one issue you need to worry about. Another critical issue is making sure you steer clear from personal liability that **can arise from the company's failure**

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to pay certain obligations (wages and taxes, in particular).

2. The relevant law here is state law, because state law, not federal law, governs most of this matter. Keep in mind, **most states at least consider Delaware law as a guide**, so don't be surprised if the company's attorney starts talking to the board about Delaware law even if the company is not organized in Delaware. Also, because much of litigation concerning claims against directors is brought in bankruptcy cases, they too are commonly relied on by attorneys (like me) as we advise corporate directors about these issues.
3. Speaking of attorneys, retain one. The company's existing law firm may be just fine, but specific attorneys it historically interacts with are likely not. Just like you wouldn't choose a great dermatologist to deliver a baby, you wouldn't choose a great IP lawyer to help navigate a financially distressed company out of trouble. After all, attorneys are extremely specialized these days. **The company needs an attorney experienced in guiding companies and boards through financial distress and corporate restructurings.**
4. As a board member you have two basic duties. Some courts and commentators describe these duties as falling into more categories but that's just a difference in nomenclature. **You can think of all fiduciary duties for a corporate director as falling into two buckets:** the duty of care and the duty of loyalty.
5. The **duty of care** requires you to make careful, well-informed decisions by assuming an active role throughout the entire decision-making process. Simply resigning when the "going gets tough" may very well be considered a breach of the duty of care.
6. The **duty of loyalty** requires you to act in the best interest of the company by not putting any personal interests ahead of the interests of the company. There are means by which a company director can transact business with the company, but she must take very careful steps before doing so.
7. If you fulfill these duties, then the decisions you make will be given substantial **deference by any court** that may be called later to review your actions.
8. There is a lot of confusion among attorneys about what happens when a company enters the "zone of insolvency." When I say, "what happens," I mean this: **if you have fiduciary duties, you might ask, "to whom do I owe these duties?"** Previously, courts generally took the view that a director owes her duties to a company's shareholders if the company is solvent; she owes her duties to creditors if the company is insolvent; and she owes her duties to both shareholders and creditors if the company is somewhere "in-between" (i.e. the zone of insolvency). However, courts struggled to apply these rules.
9. In 2006 and 2007, Delaware courts decided the party to whom duties are owed does not change as a corporation nears insolvency or becomes insolvent. Instead, Delaware courts held the party owed the fiduciary duties is always the corporation itself. **As a practical matter, this can be (and has been) used to successfully argue that boards can authorize riskier actions which have the effect of putting more risk on senior creditors while enabling parties further down the capital stack (i.e. junior creditors and equity holders) to reap any benefits.** If you don't believe me, then you can read **North American Catholic Educational Programming Foundation Inc. v. Gheewalla** and **Quadrant Structured Products Company, Ltd. v. Vertin**. However, not all state courts follow Delaware law.
10. If your company is an LLC, don't assume the above guidelines apply. Many principles are the same, but many are not.

Getting back to the question presented above – if you were surprised that the company's bank has put it into a workout and has threatened to freeze its revolver; and the company may run out of cash in two weeks, then shame on you or on the CEO because at least one of you did something wrong. Your duty of care should have caused you to stay better informed, and her duty of care should have caused her to keep you informed.

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